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Reform of the Regulation of Financial Benchmarks

The Australian Financial Markets Association (AFMA) is commenting on Reform of the Regulation of Financial Benchmarks draft legislation (Draft Law).

AFMA is a member-driven and policy-focused industry body that represents participants in Australia's financial markets and providers of wholesale banking services. AFMA's membership reflects the spectrum of industry participants including banks, stockbrokers, dealers, market makers, market infrastructure providers and treasury corporations. AFMA has been closely involved in the development of the benchmark regulation framework over the last four years particular through dialogue with the Council of Financial Regulators process.

AFMA supports the introduction of regulatory framework for benchmark administration which is consistent with the IOSCO Principles (Principles). Generally, the licensing framework in the Draft Law is consistent with the Principles. The more practical questions relating to how well this regime will function cross-border, particularly its interaction with the European Union benchmark regulation, remains an area of some uncertainty, but will be mostly determined at the administrative level through the ASIC rules which are currently out for consultation through ASIC CP 292.

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1. Benchmark Manipulation Offence – section 908DA

The principal focus of AFMA's comments in this consultation is on section 908DA which is flawed in concept and is likely because of its breadth and vagueness to result in market participants addressing their compliance risk by simply not entering into transactions on a market if the data from that trading will be used in a benchmark. The Government is strongly urged not to proceed with section 908DA in its current form. AFMA considers that this provision would actively discourage participation in markets and is a threat to well-functioning markets.

As it is currently drafted, section 908DA draws on legal concepts which find their source in case law around dealing in securities in liquid and readily traded markets (such as shares covered by a major index) and applies these concepts to a broad class of benchmarks (which can often relate to illiquid markets where occasional single transactions may have a noticeable impact on price). This creates a great deal of legal uncertainty and compliance risk.

Legal uncertainty has already impacted on market participants' willingness to provide data for the calculation of benchmark rates or to trade if data resulting from such trades is used in the calculation of a benchmark. The law must give confidence to market participants that they may trade in markets to meet their commercial needs and not be penalised if prices are affected. Otherwise the price formation role of markets is undermined and confident participation in the market is discouraged.

Uncertain law coupled with the broad coverage to any reference rate of the offences would potentially have a significant impact on the development of new benchmarks and the abandonment of existing non-significant benchmarks, including reference rates.

Artificial price

In the context of the broad range of benchmarks covering quite different asset classes to which the offence and civil penalty will and could apply, the use of the concept of artificial price, which draws on existing law which suggests that 'artificial' is contrary to genuine supply and demand, may prove to be highly problematic unless it is recognised that the factors relevant to determining what constitutes an artificial price may differ according to the market in question. Leading cases on market manipulation have so far been based on share ramping cases. The case analysis proceeds on the existence of liquid markets where supply and demand for shares can be more easily discerned based on traditional asset-pricing theory which assumes that all assets are liquid and readily tradable by economic agents. It is important to appreciate that many important classes of financial instruments are not readily liquid, and agents often cannot buy and sell them immediately. Asset illiquidity has major implications for asset pricing since it changes the economics of transacting in relevant assets in a fundamental way. It is also the case that pricing is often affected by having to enter into complementary transactions as exemplified by derivatives transactions with interactive pricing dynamics at play. Jurisprudence in other jurisdictions, such as the United States, demonstrates the importance of context and

market specific analysis. Particular care needs to be exercised when making analogies with the operation of the share market.

Adding the additional overlay of having to be concerned about whether a benchmark might be at an artificial level creates an extraordinarily complex environment. It is our contention that criminal offences and civil penalty provisions should be readily recognisable based on clear forms of conduct, not abstract effects with vague causation paths.

Act of omission

The draft provision also imposes liability in relation to acts of omission, which are not defined. This is flawed from a legal point of view. It should be noted that under Australian law an omission must be an omission to perform a duty which is imposed by a law of the Commonwealth. Moral or merely contractual duties do not provide a foundation for an express or implied liability[1]. In this case there is no legal duty to perform an act imposed by law. The suggestion that a commercial decision to not trade could form the basis for a criminal prosecution or civil penalty action is repugnant to notions of legal fairness and directly discourages participation in a market if a benchmark is drawn from it. For example, it may capture a sizeable market participant in a small market who decides not to trade on a particular day (as it has no trading or funding need).

It is also unclear whether section 908DA could also apply where a legitimate trade is not included in the administrator's calculation (i.e. by omission). This example could cause issues after publication if an error is found.

Objective of the prohibition

While AFMA does not advocate the need for an additional offence provision on the basis that existing market misconduct offences in relation to dealings in financial products that underlie the calculation of benchmarks already provide ample regulatory enforcement tools and deterrence, the Government's policy objectives stated by the Treasurer in October 2016 are acknowledged. The objective of the prohibition should be directed at a person by deliberate conduct interfering with a benchmark.

2. False or misleading statements – 908DB

Section 908DB requires more definition and precise language. In its current proposed form, any person who makes a misleading statement or omission relating to generation or administration of a benchmark, including inadvertently or mistakenly, is subject to the risk of being held liable for serious penalties. This opens up the situation where good intent and human error are criminalised, which is contrary to normal community expectations around what should be subject to criminal liability. The word 'misleading'

[1] Attorney-General's Department, 'The Commonwealth Criminal Code - A Guide for Practitioners' see page 45 for a summary of the law.

should not be used. The term 'false statements or information' encompasses the misconduct to be captured.

3. Dishonest conduct offence - section 908DC

The 'dishonest conduct' offence in section 908DC is in our view redundant law. AFMA has an in-principle objection to the proliferation of offence provisions when they are a mere subset of an existing offence. It is an important policy principle of Australian criminal law that it should be clear and readily understood so as to promote observance by the general public.

Existing Criminal Code provisions such as:

- s.134.2(1) Criminal Code – obtaining a financial advantage by deception
- s.135.1(1) Criminal Code – general dishonesty – obtaining a gain
- s.135.1(3) Criminal Code – general dishonesty – causing a loss
- s.135.1(5) Criminal Code – general dishonesty – causing a loss to another

provide ample scope for prosecuting persons for dishonest conduct in relation to the generation or administration of a financial benchmark.

4. Protections

Section 908CJ provides protection for any person who complies with the rules or the compelled rules in good faith and in so doing provides information as required, and the person is protected from any liability, whether criminal or civil, in connection with performance of that duty. However, the good faith language requires greater clarity and broader scope. It does not address all conduct performed in good faith or an honest mistake, but rather it focuses only on the provision of information. The scope of protection should be expanded to include generators or administrators of significant financial benchmarks that can demonstrate reasonable controls are in place.

5. Severity of the penalties

AFMA has previously submitted to the Council of Financial Regulators that non-significant benchmarks should not be subject to criminal penalties. The proposed criminal penalties for entities and individuals that generate or administer non-significant benchmarks are unduly severe and not in keeping with community expectations and are not aligned with the Principles and penalties in other jurisdictions.

6. Breadth of benchmark definition – section 908AA

The definition of a 'financial benchmark' adopted from IOSCO is very broad. IOSCO acknowledges that the strict application of its Principles to the range of rates and prices covered by its benchmarks definition would be highly problematical in practice, especially for 'benchmarks' of limited application and use. Consequently, IOSCO states that the

Principles should be applied in a proportionate manner to benchmarks that have less economic significance.

Unfortunately, there is little practical guidance on how the Principles should be applied in a proportionate manner and the combination of the associated uncertainty with regulatory risk aversion on the part of financial entities has meant that many useful but not systemic rates have been unable to survive. Amongst other things, this has impacted on transparency in the financial system.

It is important that ASIC be given the power to exempt from coverage classes of 'financial benchmarks' which are in the nature of reference rates and to distinguish subsets of assets which are not systemically important. For example debt instruments are commonly distinguished on the basis of tenor. It is possible for a 'significant benchmark' to contain a non-systemically important tenor which should not be treated as a significant benchmark.

The dispersion of trading activity can affect the utility of reported trades for market participants. There is also quite limited use of some benchmark tenors as reference prices for contractual purposes in the financial system, which can in part be related to the prevalence of trading. Users seeking to evaluate prices will find information on instruments traded at similar points on the yield curve or in similar forward tenors to be focussed at certain points. Trading patterns demonstrate that, for the major products, a significant proportion of activity is concentrated in a small group of the most commonly traded tenors. An insufficient transaction volume on a low demand tenor makes such tenors of minor relevance as a significant reference point. This means that low demand tenors should not form part of a significant benchmark. For example, 4 and 5 month trading in BABs and NCDs should not form part of a regulated BBSW benchmark.

7. ASX bond futures settlement not a significant benchmark

The identification of 'significant benchmarks' does not align with industry views on what is 'significant' in the case of the ASX bond futures settlement. While ASX futures are an important benchmark pricing input for a quite a number of transactions for market participants, the ASX futures settlement price itself is a much less important benchmark. Given the cash settlement of ASX bond futures, by the time the settlement process occurs the open interest in the maturing contract has dropped dramatically (i.e. by >90%) and the reference futures contract for pricing input into transactions (such as EFP) would have moved to the next futures contract 24 to 36 hours beforehand. Accordingly, the settlement price itself is not a 'significant benchmark'.

8. Compulsion – sections 980CD & 980CE

In relation to section 908CD *"ASIC may make compelled financial benchmark rules"* and section 908CE *"Permitted powers and matters that may be dealt with in the rules"* there is significant industry concern with the provision of *"quotes or opinions and views, including those based on expert judgement to a benchmark administrator or ASIC on a compulsory basis*", as is described in section 3.9 of the Draft Explanatory Materials. If a decision is made by institutions to address the relevant risks by limiting transactions on a market where the data from that trading will be used in a benchmark, the requirement to compel them to provide quotes or opinions and views is not appropriate. If the benchmark is not actively traded by an institution, they may no longer have appropriate expertise to provide an informed quote or opinion to the benchmark administrator or ASIC.

Please contact David Love either on 02 9776 7995 or by email dlove@afma.com.au if further clarification or elaboration is desired.

Yours sincerely

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